Currency Carry Trades 101

BY KATHY LIEN Updated Nov 12, 2019

TABLE OF CONTENTS

EXPAND

Whether you invest in stocks, bonds, commodities or currencies, it is likely that you have heard of the carry trade. This strategy has generated positive average returns since the 1980s, but only in the past decade has it become popular among individual investors and traders.

For the better part of the last 10 years, the carry trade was a one-way trade that headed north with no major retracements. However, in 2008, carry traders learned that gravity always regains control as the trade collapsed, erasing seven years worth of gains in three months.

Yet, the profits made between 2000-2007 have many forex traders hoping that the carry trade will one day return. For those of you who are still befuddled by what a carry trade is and why the hysteria surrounding the trade has extended beyond the currency market, welcome to Carry Trades 101. We will explore how a carry trade is structured when it works when it doesn't and the different ways that short- and long-term investors can apply the strategy.

KEY TAKEAWAYS

- A currency carry trade is a strategy that involves borrowing from a low interest rate currency and to fund purchasing a currency that provides a rate.

- A trader using this strategy attempts to capture the difference between the rates, which can be substantial depending on the amount of leverage used.
- The carry trade is one of the most popular trading strategies in the forex market.
- Still, carry trades can be risky since they are often highly leveraged and over-crowded.

1:40

Currency Carry Trade

Carry Trade

The carry trade is one of the most popular trading strategies in the currency market. Mechanically, putting on a carry trade involves nothing more than buying a high yielding currency and funding it with a low yielding currency, similar to the adage "buy low, sell high."

The most popular carry trades involve buying currency pairs like the Australian dollar/Japanese yen and New Zealand dollar/Japanese yen because the interest rate spreadsof these currency pairs are very high. The first step in putting together a carry trade is to find out which currency offers a high yield and which one offers a low yield.

As of June 2010, the interest rates for the most liquid currencies in the world were as follows:

Australia (AUD)	4.50%
New Zealand(NZD)	2.75%
Eurozone (EUR)	1.00%
Canada (CAD)	0.50%
U.K. (GBP)	0.50%
U.S. (USD)	0.25%

Swiss franc (CHF)	0.25%
Japanese yen (JPY)	0.10%

With these interest rates in mind, you can mix and match the currencies with the highest and lowest yields. Interest rates can be changed at any time so forex traders should stay on top of these rates by visiting the websites of their respective central banks.

Since New Zealand and Australia have the highest yields on our list while Japan has the lowest, it is hardly surprising that AUD/JPY is the poster child of the carry trades. Currencies are traded in pairs so all an investor needs to do to put on a carry trade is to buy NZD/JPY or AUD/JPY through a forex trading platform with a forex broker.

The Japanese yen's low borrowing cost is a unique attribute that has also been capitalized by equity and commodity traders around the world. Over the past decade, investors in other markets have started to put on their own versions of the carry trade by shorting the yen and buying the U.S. or Chinese stocks, for example. This had once fueled a huge speculative bubble in both markets and is the reason why there has been a strong correlation between the carry trades and stocks.

The Mechanics of Earning Interest

One of the cornerstones of the carry trade strategy is the ability to earn interest. The income is accrued every day for long carry trades with triple rollover given on Wednesday to account for Saturday and Sunday rolls.

Roughly speaking, the daily interest is calculated in the following way:

$$\text{Daily Interest} = \frac{\text{IR}_{\text{Long Currency}} - \text{IR}_{\text{Short Currency}}}{365 \text{ Days}} \times \text{NV}$$

where:

$\text{IR} = \text{interest rate}$

$\text{NV} = \text{notional value}$

For example, using a 1 lot of AUD/JPY that has a notional of $100,000, we compute interest the following way:

$$\frac{.0450 - 0.001}{365} \times \$100,000 \cong \$12 \text{ per day}$$

The amount will not be exactly $12 because banks will use an overnight interest rate that will fluctuate on a daily basis.

It is important to realize that this amount can only be earned by traders who are long AUD/JPY. For those who are fading the carry, or shorting AUD/JPY, the interest is paid every day.

Why This Strategy Is So Popular

Between January 2000 and May 2007, the Australian dollar/Japanese yen currency pair (AUD/JPY) offered an average annual interest of 5.14%. For most people, this return is a pittance, but in a market where leverage is as high as 200:1, even the use of five- to 10-times leverage can make that return extremely extravagant. Investors earn this return even if the currency pair fails to move one penny. However, with so many people addicted to the carry trades, the currency almost never stays stationary. For example, between February and April of 2010, the AUD/USD exchange rate gained nearly 10%. Between January 2001 and December 2007, the value of the AUD/USD increased approximately 70%.

Source: Dealbook 360

Figure 1

Low Volatility, Risk Friendly

Carry trades also perform well in low volatility environments because traders are more willing to take on risk. What the carry traders are looking for is the yield—any capital appreciation is just a bonus. Therefore, most carry traders, especially the big hedge

fundsthat have a lot of money at stake, are perfectly happy if the currency does not move one penny, because they will still earn the leveraged yield.

As long as the currency doesn't fall, carry traders will essentially get paid while they wait. Also, traders and investors are more comfortable with taking on risk in low volatility environments.

Central Banks and Interest Rates

Carry trades work when central banks are either increasing interest rates or plan to increase them. Money can now be moved from one country to another at the click of a mouse, and big investors are not hesitant to move around their money in search of not only high but also increased yield. The attractiveness of the carry trade is not only in the yield but also the capital appreciation. When a central bank is raising interest rates, the world notices and there are typically many people piling into the same carry trade, pushing the value of the currency pair higher in the process. The key is to try to get into the beginning of the rate tightening cycle and not the end.

The profitability of the carry trades comes into question when the countries that offer high-interest rates begin to cut them. The initial shift in monetary policy tends to represent a major shift in trend for the currency. For carry trades to succeed, the currency pair either needs to not change in value or appreciate.

When interest rates decrease, foreign investors are less compelled to go long the currency pair and are more likely to look elsewhere for more profitable opportunities. When this happens, demand for the currency pair wanes and it begins to sell off. It is not difficult to realize that this strategy fails instantly if the exchange rate devalues by more than the average annual yield. With the use of leverage, losses can be even more significant, which is why when carry trades go wrong, the liquidation can be devastating.

Central Bank Risk

Carry trades will also fail if a central bank intervenes in the foreign exchange market to stop its currency from rising or to prevent it from falling further. For countries that are export-dependent, an excessively strong currency could take a big bite out of exports while an excessively weak currency could hurt the earnings of companies with foreign operations. Therefore if the Aussie or Kiwi, for example, gets excessively strong, the central banks of those countries could resort to verbal or physical intervention to stem the currency's rise. Any hint of intervention could reverse the gains in the carry trades.

If It Were Only This Easy!

An effective carry trade strategy does not simply involve going long a currency with the highest yield and shorting a currency with the lowest yield. While the current level of the interest rate is important, what is even more important is the future direction of interest rates. For example, the U.S. dollar could appreciate against the Australian dollar if the U.S. central bank raises interest rates at a time when the Australian central bank is done tightening. Also, carry trades only work when the markets are complacent or optimistic.

Uncertainty, concern, and fear can cause investors to unwind their carry trades. The 45% sell-off in currency pairs such as the AUD/JPY and NZD/JPY in 2008 was triggered by the Subprime turned Global Financial Crisis. Since carry trades are often leveraged investments, the actual losses were probably much greater.

Best Way to Trade Carry

When it comes to the carry trades, at any point in time, one central bank may be holding interest rates steady while another may be increasing or decreasing them. With a basket that consists of the three highest and the three lowest yielding currencies, any one currency pair only represents a portion of the whole portfolio; therefore, even if there is carry trade liquidation in one currency pair, the losses are controlled by owning a basket. This is actually the preferred way of trading carry for investment banks and hedge funds. This strategy may be a bit tricky for individuals because trading a basket would naturally require greater capital, but it can be done with smaller lot sizes.

The key with a basket is to dynamically change the portfolio allocations based upon the interest rate curve and monetary policies of the central banks.

Benefiting from the Carry Trade

The carry trade is a long-term strategy that is far more suitable for investors than traders because investors will revel in the fact that they will only need to check price quotes a few times a week rather than a few times a day. True, carry traders, including the leading banks on Wall Street, will hold their positions for months (if not years) at a time. The cornerstone of the carry trade strategy is to get paid while you wait, so waiting is actually a good thing.

Partly due to the demand for the carry trades, trends in the currency market are strong and directional. This is important for short-term traders as well because in a currency pair where the interest rate differential is very significant it may be far more profitable to look for opportunities to buy on dips in the direction of the carry than to try to fade it. For those who insist on fading AUD/USD strength, for example, they should be wary of holding short positions for too long because, with each passing day, more interest will need to be paid. The best way for shorter-term traders to look at interest is that earning it helps to reduce your average price while paying interest increases it. For an intraday trade, the carry will not matter, but for a three-, four- or five-day trade, the direction of carry becomes far more meaningful.